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In the Supreme Court of the United States

OCTOBER TERM, 1986

LEROY FRANTZ, JR., ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether the non-pro-rata surrender by a corporation's dominant shareholder of his non-voting preferred stock in order to improve the corporation's financial position gives rise to an immediately deductible loss in the computation of the shareholder's taxable income.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-22a) is reported at 784 F.2d 119. The opinion of the Tax Court (Pet. App. 23a-67a) is reported at 83 T.C. 162.

JURISDICTION

The judgment of the court of appeals was entered on February 19, 1986. A petition for rehearing was denied on April 8, 1986 (Pet. App. 1a-2a). The petition for a writ of certiorari was filed on July 7, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In June 1971, petitioner Leroy Frantz, Jr.,[1] acquired 13% of the non-voting preferred stock (16,000 shares) and 65% of the common stock (276,250 shares) of Andree Baillot, Ltd. (ABL), a New York corporation that was experiencing financial difficulties. Prior to that time, petitioner had been a creditor of ABL, but not a shareholder. Petitioner acquired the preferred stock in exchange for ABL notes that he held by virtue of his previous advances to the company; on the date of the exchange, those notes had a fair market value of $32,000 (Pet. App. 26a-27a). Petitioner acquired the common stock for $150,000 in cash (*id.* at 28a). Upon his acquisition of these equity interests petitioner became chairman of ABL's board of directors. *Id.* at 7a-8a, 17a, 25a-29a, 34a.

Between June 1971 and July 1973, petitioner advanced $208,600 in cash to ABL, of which $50,000 represented "senior indebtedness" for which petitioner received a non-interest-bearing note (Pet. App. 29a-30a). Despite these cash infusions, the financial condition of ABL continued to deteriorate, and petitioner took steps to enhance the possibility of raising outside capital. On May 4, 1973, and November 9, 1973, petitioner surrendered to the corporation all of his ABL preferred stock, and he cancelled all notes and accounts receivable due him from ABL, contributing them "to the capital of the Company" (*id.* at 31a-32a). In return, ABL agreed to accept petitioner's "contribution * * * to its capital" for the stated purpose of improving its financial position so that it

[1] Sheila Frantz is a party solely by virtue of having filed a joint federal income tax return with her husband for the tax year at issue. For convenience, we will refer to Leroy Frantz, Jr., as "petitioner."

might more easily attract new outside investment (*ibid.*). No similar surrender of shares or cancellation of indebtedness was made by any other ABL shareholder. A little over a month later, on December 27, 1973, petitioner sold his entire holding of ABL common stock—that is, the 276,250 shares that he had purchased in 1971—for $8,000 (*id.* at 33a).

2. On his federal income tax return for 1973, petitioner claimed an ordinary loss of $210,600 [2] on his surrender of the notes and accounts receivable to ABL, and an ordinary loss of $32,000 on his surrender of the preferred stock. He also claimed a loss of $142,000 on his sale of the common stock. Of that latter amount, petitioner claimed that $50,000 represented an ordinary loss under Section 1244 of the Code,[3] and that the remaining $92,000 represented a long-term capital loss. Pet. App. 8a-9a, 33a.

On audit, the Commissioner determined that petitioner's surrender of the preferred stock and the instruments of indebtedness constituted contributions to ABL's capital, and he therefore disallowed petition-

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[2] Petitioner later conceded that this amount should have been $208,600, the amount of his cash advances to the corporation between June 1971 and July 1973 (Pet. App. 34a).

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.). During the taxable year at issue, Section 1244 permitted taxpayers filing a joint return to treat a loss realized upon the disposition of certain "small business stock" as an ordinary rather than a capital loss, subject to a ceiling of $50,000. 26 U.S.C. (1976 ed.) 1244(b)(2). The Tax Court (Pet. App. 51a-57a), affirmed by the court of appeals (*id.* at 19a-20a), held that the ABL common stock did not meet the requirements of Section 1244, and therefore it reclassified the $50,000 loss as a long-term capital loss. Petitioner does not appear to seek certiorari on this issue.

er's claim of ordinary losses on those surrenders. Consistent with that determination, the Commissioner increased the basis of petitioner's common stock by the amount of petitioner's basis in the surrendered stock and debt, thereby increasing, by an identical amount, the magnitude of petitioner's capital loss on the December 1973 sale of his common stock. Pet. App. 9a, 33a-34a. Thus, the overall effect of the Commissioner's determination was to leave unchanged the total amount of loss that petitioner claimed, but to reclassify that loss as a capital loss in its entirety, rather than partially as an ordinary loss.

3. The Tax Court, in a reviewed decision with four judges dissenting, sustained the Commissioner's determination (Pet. App. 23a-67a). The court acknowledged that a line of its prior cases had pointed the opposite way (see, *e.g.*, *Downer* v. *Commissioner*, 48 T.C. 86 (1967); *Wright* v. *Commissioner*, 18 B.T.A. 471 (1929), modified, 47 F.2d 871 (7th Cir. 1931)), but it decided that it was appropriate to reexamine those cases in light of recent court of appeals decisions that had reversed the Tax Court on this point (Pet. App. 38a-45a). See *Schleppy* v. *Commissioner*, 601 F.2d 196 (5th Cir. 1979) (non-pro-rata stock surrender); cf. *Tilford* v. *Commissioner*, 705 F.2d 828 (6th Cir.), cert. denied, 464 U.S. 992 (1983) (stockholder's sale of stock at a nominal price to employees of his corporation to induce them to accept or continue employment). On the merits, the Tax Court concluded that, because the purpose of petitioner's surrender of his preferred stock was to improve ABL's financial condition and hence to protect or enhance his own controlling common stock interest, petitioner had not "sustained a loss at the time of the [surrender]" (Pet. App. 50a).

The court accordingly held that he was not entitled to treat the stock surrender as giving rise to an ordinary loss; instead, the proper tax treatment was to treat the surrender as a contribution to ABL's capital and to add the basis of the preferred shares surrendered to the basis of the common shares retained, thus increasing petitioner's capital loss upon the December 1973 sale of his common stock. *Id.* at 46a-51a.

The Tax Court also held that petitioner's cancellation of the indebtedness owed to him by ABL did not give rise to an ordinary loss, citing the well-settled principle that "the cancellation of a debt owed by a corporation to its shareholder-creditor to improve [its] financial structure * * * constitutes a contribution to the [corporation's] capital." Pet. App. 35a, citing Treas. Reg. § 1.61-12(a). Although petitioner contended that his loans to ABL in reality constituted "equity" rather than debt, and hence that his cancellation of the indebtedness should be viewed as tantamount to a surrender of stock, the Tax Court found no need to reach this contention in view of its holding that a stock surrender does not generate an ordinary loss either (Pet. App. 36a-37a). The court noted in passing that the Commissioner appeared to have "the better argument on th[is] issue and was fully justified in treating the advances as loans" (*id.* at 38a n.7).

The court of appeals affirmed (Pet. App. 3a-22a). It noted that "[p]ayments made to further ongoing investments are not normally considered losses, but rather [are] capital expenditures" (*id.* at 13a). The court cited several factors that persuaded it that petitioner's surrender of his preferred stock "was properly treated by the Tax Court as a contribution to

the capital of ABL, as it had expressly been labeled by the parties at the time of the surrender" (*id.* at 18a). Although petitioner surrendered his 13% interest in ABL's preferred stock, he retained control of the corporation at the time of the surrender by means of his undiminished 65% voting common stock interest (*ibid.*). Moreover, because the value of that common stock interest was increased by virtue of his surrender of the preferred shares, "the overall change in [petitioner's] interest in ABL was miniscule compared with [his] retained interest in the company" (*ibid.*). The court accordingly found no justification for treating the preferred stock surrender as giving rise to a "loss." Finally, the court noted that acceptance of petitioner's contention would enable a taxpayer "to manipulate his holdings for tax advantages that would not be available if he sold his shares without any such interlocking of his equity interests in the corporation" (*ibid.*). The court of appeals accordingly "affirm[ed] the Tax Court's decision with respect to the surrender of the preferred stock," noting that its holding was limited to the facts of the particular case and "should not be construed as governing surrenders by a stockholder of more substantial equity interests that could truly be viewed as resulting in an immediate loss" (*ibid.*). Judge Winter concurred in the result on the stock surrender point, expressing his "preference for a clear cut rule" that stock surrenders can never give rise to ordinary losses (*id.* at 18a-22a).

The court of appeals also affirmed the Tax Court's holding that petitioner's surrender of debt to ABL did not generate an ordinary loss, stating that this question "present[ed] less of a problem than that confronted with respect to [petitioner's] surrender of

the preferred stock" (Pet. App. 18a-19a). Unlike the Tax Court, however, the court of appeals apparently found it necessary to reach petitioner's contention that his cash advances to ABL should "be classified as 'equity,'" a contention that the court proceeded to reject (*id.* at 19a). It noted that the advances were labeled as "loans" on ABL's books and that the Tax Court had suggested that the Commissioner "'was fully justified in treating the advances as loans'" (*ibid.* (quoting 83 T.C. at 173 n.7)). The court of appeals accordingly "agree[d] with the Tax Court that the cancellations were not deductible as losses but represented contributions to the capital of ABL" (Pet. App. 19a).

DISCUSSION

Petitioner correctly points out (Pet. 12-13) that the portion of the decision below denying him an ordinary loss deduction for the surrender of his preferred stock conflicts with the Sixth Circuit's decision in *Fink* v. *Commissioner*, 789 F.2d 427 (1986), in which we are today filing a petition for a writ of certiorari. For the reasons set forth in detail in that petition, we believe that this conflict is irreconcilable and that the question is sufficiently important to warrant this Court's review. Although we do not oppose certiorari here, we believe that *Fink* is a slightly better vehicle for resolving the existing circuit conflict. We therefore believe that it would be appropriate for the Court to grant certiorari in *Fink* and to hold this case pending the disposition of that case.

Petitioner phrases the first question presented here as "[w]hether the constitutional doctrine of separation of powers was violated" by the Tax Court's decision (Pet. i). But this case plainly presents no

"separation of powers" issue; the question is one of statutory construction concerning the proper tax treatment of a particular corporate securities transaction. The thrust of petitioner's discussion (Pet. 5-12) is that previous Tax Court cases supportive of his position are lent additional weight by the fact that Congress took no action to overturn them by statutory amendment. Whatever the merit of that argument (and we think it has little merit),[4] it does not raise any sort of constitutional issue. Rather, it is simply an argument in favor of the statutory construction that petitioner advances. See Pet. App. 20a n.4; *Fink* v. *Commissioner*, 789 F.2d at 433.

Petitioner's phrasing of the second question presented (Pet. i) leaves us somewhat uncertain as to which aspects of the decision below he is asking this Court to review. The instant case involves not only a surrender of stock—the issue common to this case and *Fink*, and upon which the circuits are in conflict—but also a surrender of debt. The courts below, adopting different theories, held that neither sort of surrender entitled petitioner to an ordinary loss deduction, and certain passages in the petition suggest that petitioner is seeking review of both holdings. See, *e.g.*, Pet. 4. Review of the court of appeals' holding as to the debt surrender in turn could entail consideration of petitioner's contention (Pet. App. 18a-19a) that the debt was really "equity," an essen-

[4] This Court has noted that the "legislative reenactment" doctrine—namely, the theory that Congress has incorporated a prior judicial gloss on a statute by reenacting it without change—is an "unreliable indicium at best." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). Here, petitioner has pointed to nothing indicating that Congress considered, or was even aware of, the old Tax Court decisions on which he relies.

tially factual contention that the Tax Court found unnecessary to reach (*id.* at 37a-38a & n.7). For this reason, we believe that the question on which the circuits are in conflict is presented more cleanly in *Fink* than in the instant case.

Finally, the factual situation here, involving a dominant shareholder's surrender of all of his preferred stock, presents a scenario that is fairly atypical. The more usual pattern involves a dominant shareholder's surrender of a portion of his common shares, with some consequent reduction of his ownership interest. Compare, *e.g.*, *Schleppy* v. *Commissioner*, *supra*. It is that more typical scenario that is presented in *Fink*. The facts of the instant case are also unusual in that petitioner sold all of his common stock in the same tax year in which he made the stock surrender. Thus, petitioner was entitled to a loss under any view of the law, and the only question is whether that loss should be characterized as capital or ordinary. In *Fink*, by contrast, the taxpayers retained the bulk of their common stock at the close of the tax years in which the stock surrenders occurred, so that their ability to take a loss at all in the taxable years is at issue in that case. For these reasons as well, we believe that *Fink* represents a somewhat better vehicle for resolving the circuit conflict.

CONCLUSION

If certiorari is granted in *Commissioner* v. *Fink*, the instant petition should be held pending disposition of that case. Alternatively, certiorari should be granted in the instant case and our petition in *Fink* should be held pending disposition here.

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